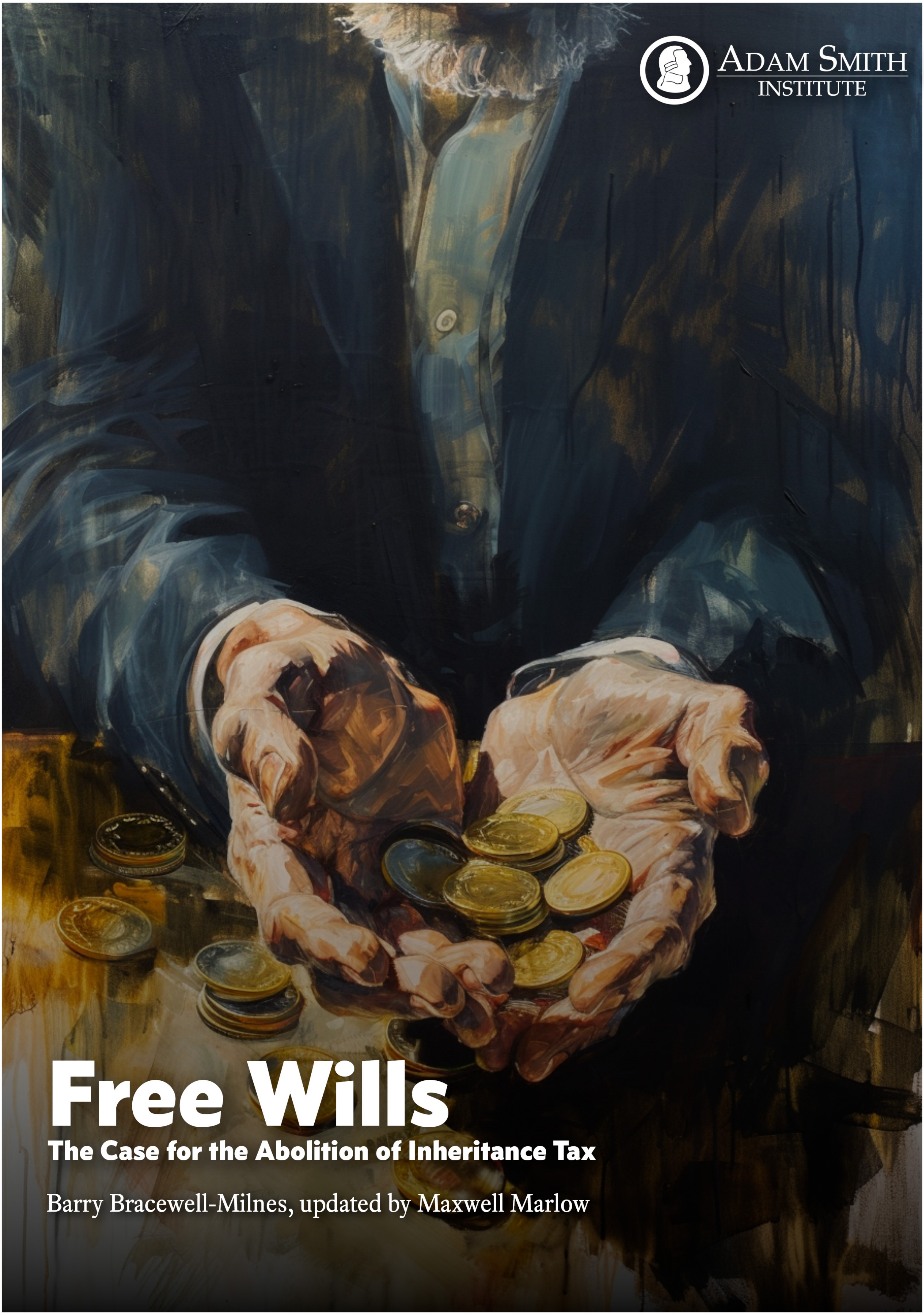

ADAM SMITH INSTITUTE

Free Wills

The Case for the Abolition of Inheritance Tax

Barry Bracewell-Milnes, updated by Maxwell Marlow

About the Authors

Barry Bracewell-Milnes (1931-2012) was an Adam Smith Institute author of six papers, ranging from inheritance tax to alcohol duties to capital gains tax. He was chairman of the Executive Committee of the Society for Individual Freedom, and was the Economic Director of the Confederation of British Industry.

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Cover Image - Maxwell Marlow

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Executive Summary

1. Inheritance tax is an old-fashioned tax that has lost any rationale it may have had in earlier times.

2. Inheritance tax yields a very small proportion of total tax revenue, raising £7.1bn in revenue in 2022-23, or 0.89% of total tax revenues collected in 2022.[1] Its costs of collection are exceptionally high. It imposes a large burden on those who pay the tax.

3. When account is taken of the effect on other taxes and on economic activity, the yield of inheritance tax to the Treasury may well be zero or negative.

4. The yield of estate duty may well have been negative in each of the hundred years since its introduction in 1894. Inheritance tax has served to increase unemployment, and the present economic difficulties would have been less severe if death duties had been abolished a generation ago.

5. The damaging short-termist distortions caused by inheritance tax should be removed by the abolition of the tax.

6. It is not only heritage assets and family firms, but assets in general, that are best and most efficiently looked after by long-term family owners acting to some degree in the quality of stewards. This socially desirable activity of stewardship is inhibited or prevented by death duties.

7. Death duties also damage the economy by frustrating the creation of wealth through giving and bequest.

8. The redistributive effects of inheritance tax are perverse, in that it cheapens the rich man's spending relatively both to his own saving and to the spending of the poor. It is thus the exact opposite of a sumptuary tax. Inheritance tax is a tax on middle wealth and rising wealth. Among other perverse consequences, inheritance tax militates against giving employees of unquoted companies an interest in these companies as shareholders. And taxes on personal ownership and giving are taxes on vocation and commitment.

9. A rising standard of living should be reflected in ownership of assets increasing from each generation to the next through the institution of inheritance without taxation.

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1 "HMRC Tax Receipts and National Insurance Contributions for the UK (Monthly Bulletin)," GOV.UK, accessed February 7, 2024, https://www.gov.uk/government/statistics/hmrc-tax-and-nics-receipts-for-the-uk/hmrc-tax-receipts-and-national-insurance-contributions-for-the-uk-new-monthly-bulletin#inheritance-tax-iht.

Foreword

When I first set about publicly calling for the abolition of inheritance tax, both the moral and the economic cases felt instinctive. This is a feeling I share with many across the UK, and is perhaps why respondents to a poll on the subject deemed it the most unfair tax we levy.

The thought of a grieving family opening the door to death's knock, only to find that the tax-man is waiting just two steps behind, is deeply unsettling. It seems obvious, too, that such a complicated tax with a vast and confusing array of technical exemptions and carve-outs would place huge financial burdens on the individuals who are expected to be able to declare what is or is not taxable, and would distort the economy in ways we would never have consciously intended. It fundamentally cannot be right that what individuals should do best with their money or the success of a family business hinges upon the unpredictable lottery of death.

In order to add intellectual grounding to what already seemed evident, I turned to a research paper published by the Adam Smith Institute in 1995. The research team and I were struck by how the arguments in favour of the abolition of inheritance tax made almost thirty years ago still resonated just as clearly as today. In fact, many of them have become even more prescient; the paperwork that must be filled out has almost quintupled in length and individuals have less personal stake in business- all for a tax that is now taking up an even smaller percentage of our total tax take. This is to say nothing of the fact that fiscal drag has meant that more and more families are being pulled into paying a tax that was originally intended for the very richest.

You are reading the result of this striking realisation now. *Free Wills,* newly updated since its original publication in the '90s, outlines both the negative knock-on impacts that inheritance tax continues to have on the most entrepreneurial parts of our economy, and, conversely, the potential benefits of its removal from our tax code.

The Treasury's current method of costing any changes to inheritance tax assumes that the economy is static, rather than dynamic. As this paper correctly outlines, we should instead properly consider the impact that any adjustments to inheritance tax might have on levels of income, spending and saving.

I commend this report to any reader in pursuit of an enhanced understanding of the wide-ranging effects of inheritance tax on our economy and on our society at large.

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The Rt Hon Nadhim Zahawi MP
Former Chancellor of the Exchequer, and Member of Parliament for Stratford-Upon-Avon

February 2024

Introduction

Inheritance tax (IHT) is a form of death tax introduced in the United Kingdom in 1986. Like its predecessors, capital transfer tax and estate duty, it is levied on the estate of the deceased; no separate charge is incurred by the heirs. By way of support for the death tax, inheritance tax is also levied on gifts made within seven years of death.

At the time of writing, it is charged at a proportional rate of 40 per cent above a threshold of £325,000. 577,160 people die in the England and Wales in 2022 and less than 27,000 estates pay inheritance tax (4 per cent)[2]; the remainder fall below the threshold or within one or more of the various exemptions.

Although the rate of tax is still historically high, the yield, at £5.2bn was collected from April to November 2023 (forecast for £7.6bn in 2023-24)[3], is relatively low, less than a penny on the basic rate of income tax and 0.89 per cent of total HMRC tax receipts (it was 19 per cent in 1908-09). Post-war attempts to increase the yield have had limited success, not least because death duties are avoidable through emigration and other forms of taxpayer resistance.

Possibility of Change

For several decades after the War it was widely regarded as politically impossible to make substantial reductions in the rates of death duties. Even if this was true at the time, it is no longer true now.

As a result of increases in the prices of shares and residential property, more taxpayers are liable to inheritance tax than ten years ago. Death duties have few committed supporters outside (or perhaps even inside) academic, political, and other specialist circles. The cuts in the top rate of tax to 60 per cent and then to 40 per cent were well received, although recent increases in income tax in Scotland have been met with strong rebuttal.[4] Nonetheless, critics of inheritance tax are increasingly confident and assured in calling for its abolition.

Similar trends have been found elsewhere: in the 1990s, death duties have been abolished in Australia, Canada and much of East Asia and the Pacific, and these reforms have generally been well received. Likewise, Austria, Portugal, Sweden, and Norway have all abolished inheritance taxes and death duties since 2003.[5]

Domestically, there is considerable opposition to IHT. There have been multiple polls on the tax, with a recent poll by WeThink concluding that 75% of voters believing that IHT is unfair.[6] Likewise, a YouGov poll found that 42% of Britons believe that IHT is double taxation, and thus,

2 "All Data Related to Death Registration Summary Statistics, England and Wales: 2022," All data related to Death registration summary statistics, England and Wales: 2022 - Office for National Statistics, accessed February 8, 2024, https://www.ons.gov.uk/peoplepopulationandcommunity/birthsdeathsandmarriages/deaths/articles/deathregistrationsummarystatisticsenglandandwales/2022/relateddata; "Inheritance Tax Statistics: Commentary," GOV.UK, accessed February 8, 2024, https://www.gov.uk/government/statistics/inheritance-tax-statistics-commentary/inheritance-tax-statistics-commentary.

3 "Public Finances Databank, England and Wales, Novemver 2023", Office for Budget Responsibility, accessed February 8, 2024, https://obr.uk/download/public-finances-databank-november-2023/?tmstv=1704709112

4 Scottish Income Tax Hike Poses "serious Risks" to Economy, Claims Andrew Wilson | The National', accessed 23 December 2023, https://www.thenational.scot/news/24008631.scottish-income-tax-hike-poses-serious-risks-economy-claims-andrew-wilson/.

5 Reforming Inheritance Tax', Institute for Fiscal Studies, 27 September 2023, https://ifs.org.uk/publications/reforming-inheritance-tax.

6 Madeleine Ross, "Labour Voters Dislike Inheritance Tax More than Tories Do, Poll Reveals," The Telegraph, November 21, 2023, https://www.telegraph.co.uk/money/tax/inheritance/labour-voters-dislike-inheritance-tax-more-than-tories-poll/.

double taxation.[7] This results in an opposition of 56% of Britons believeing that IHT should be scrapped.[8] However, there has been polling, commissioned by the think tank Demos, that shows that the majority of those polled would rather Government spent money on the NHS rather than on scrapping IHT.[9] This is supplemented by research by IPSOS, which found that it was only the 6th most concerning tax faced by individuals in the UK.[10] Overall, IHT is seen as unfair by individuals, although how it should be considered in general debates over tax is up for debate.

Cultural and social costs

The increase in business property relief to 100 per cent enacted in 1992 (though only for holdings more than 25 per cent) was a response to the increasing recognition by government of the damage done by death duties to family firms. In many parts of the country, the culture of long-term family businesses has been largely destroyed by death duties.

When family firms go under through death duties, the loss is social and cultural as well as regional and economic; in particular, when an unquoted family company is bought by a quoted company, the time horizon shortens and the economic activity, if it continues at all, becomes exposed to short-termist pressures to which it was largely immune before.

Similarly, if death duties compel a taxpayer to part with assets of heritage character, there is often no one else who will look after them as well or as cheaply as the owner, and they may be lost through neglect and decay.

Inheritance tax is also an immoral tax in the precise sense that it punishes virtue and rewards the government for the dereliction of its duty. A charge to inheritance tax may be incurred by a taxpayer killed to save somebody's life or by a taxpayer killed in street violence which it is the government's duty to prevent.

If inheritance tax did not exist already, it is unlikely that it would be introduced now. Its main support is political inertia. But the arguments for abolishing the tax are stronger than the arguments for retaining it in several different dimensions.

YIELD AND COSTS

Inheritance tax is not important as a revenue raiser; but the direct and indirect costs that it imposes are high by comparison with its yield.

Modest yield of inheritance tax

Estate duty was introduced in 1894 and was replaced by capital transfer tax in 1975, which was in turn replaced by inheritance tax in 1986. By 1908- 09, the yield of estate duty had risen to £18m, which was more than half the yield of income tax (£34m) and 19 per cent of the total yield of Inland

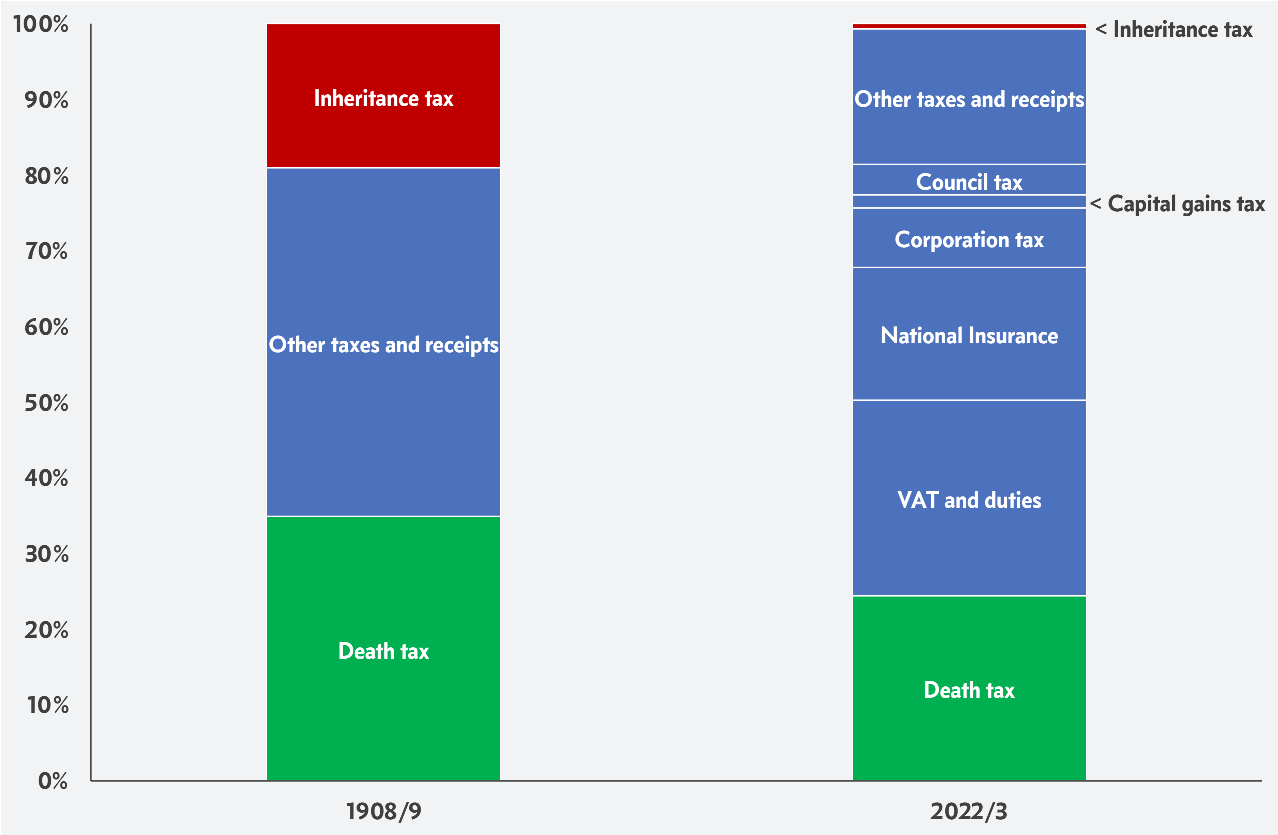
7 Matthew Smith, "Why Do Britons Think Inheritance Tax Is Unfair?," YouGov, November 23, 2023, https://yougov.co.uk/politics/articles/47940-why-do-britons-think-inheritance-tax-is-unfair.

8 Ibid.

9 "'£7 Billion Electoral Gamble' to Abolish Inheritance Tax Unlikely to Pay off, According to New Research," Demos, December 11, 2023, https://demos.co.uk/blogs/7-billion-electoral-gamble-to-abolish-inheritance-tax-unlikely-to-pay-off-according-to-new-research/.

10 Inheritance tax seen as an unfair tax but others are ..., accessed February 7, 2024, https://www.ipsos.com/en-uk/inheritance-tax-seen-unfair-tax-others-are-prioritised-cuts.

Revenue taxes. By 1993-94 death duties in the form of inheritance tax had risen to £1.3bn; but income tax had risen much faster to £57.5bn: inheritance tax was 2.3 per cent of income tax, 1.7 per cent of total Inland Revenue taxes and 0.6 per cent of taxation in total.[11] For some years inheritance tax has yielded less than an extra penny on the basic rate of income tax.



In 1989-90, 276.4 thousand estates passing on death had a net capital value of £20.12bn. 45.3 per cent of assets were UK residential buildings,

21.4 per cent cash and interest-bearing accounts, 12.4 per cent listed company securities, 20.9 per cent other. Net receipts from inheritance tax were £1.232bn; 50.4 per cent of tax came from estates under £500,000.

In 2019-20, 27,000 estates paid death duties, raising the Treasury £7.1bn in net receipts, of a total capital stock of £92.9bn of 278 thousand estates. Of such estates, 72.9 per cent contained UK residential buildings, 96.4 per cent contained cash, and 34.7% contained securities. Most of the revenue was transferred from those in the threshold of £100,000, then £200,000, and £300,000, respectively.

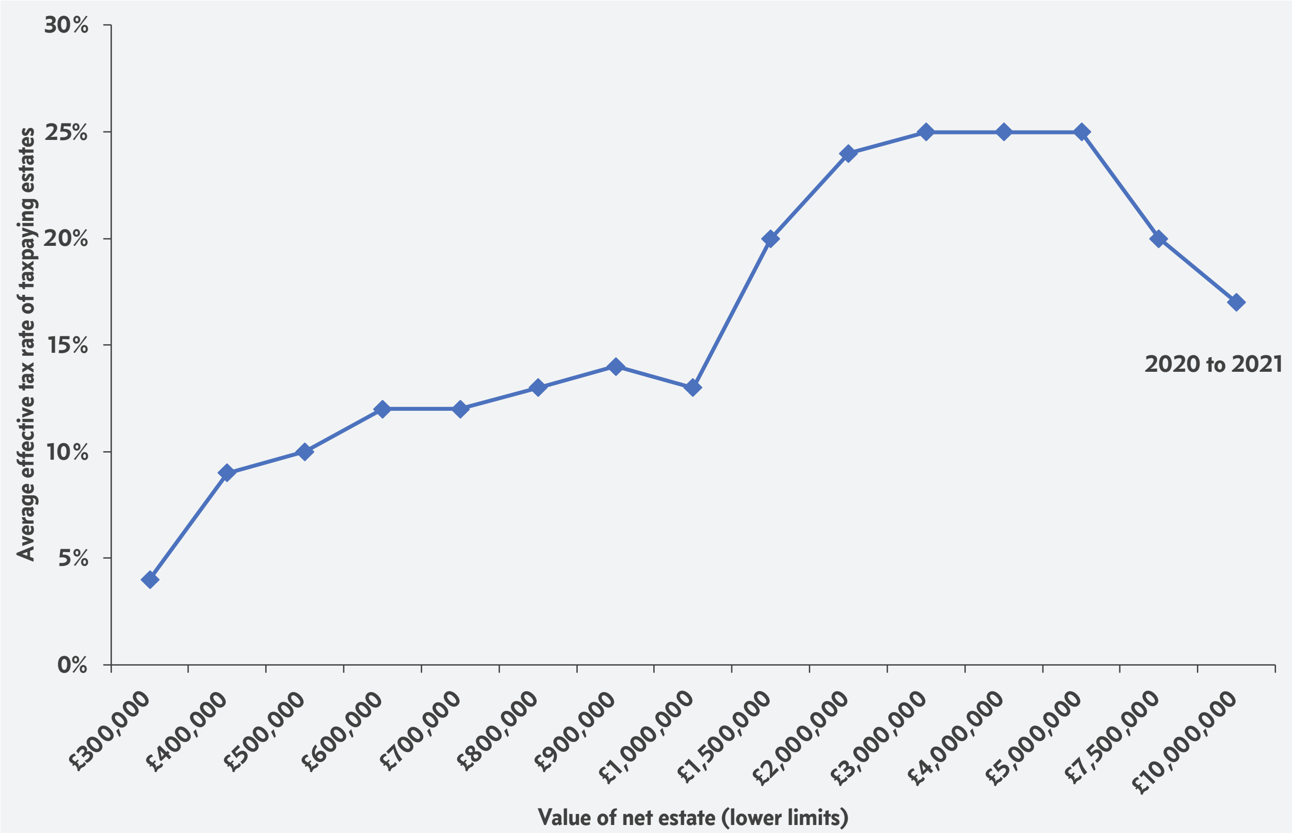
Administrative Costs

Administrative costs for all HMRC taxes totalled £6.4bn in 2023-24 or >1% per cent of the £814 bn total tax revenue. This corresponds to a percentage of 0.0.8%.

The cost of administering inheritance tax/capital transfer tax/ estate duty was 2.4 per cent of the yield in 1986-87 and 2.16 per cent in 1992-93. In 2023, the cost is £35m, or 0.543%. However, as the inheritance tax is self-assessed, we can assume that there is a significant standard error in these calculations. Burgherr estimates that the central cost to taxpayers is 10% of the cost of the

11 Office for Budget Responsibility, https://obr.uk/download/public-finances-databank-november-2023/?tmstv=1704729814

taxable estate, whilst the cost of administration by HMRC is 5% of the cost of the estate.[12] Taking a standard distribution of taxable estates, we can estimate that the costs to taxpayers would be ~£100m.



HRMC are involved in the administration of inheritance tax on large estates and in the valuation of significant holdings of unquoted company shares; but for the majority of estates inheritance tax relies on the complete and accurate disclosure of wealth by the executors of the estate.

Compliance costs

CT Sandford, in his 1988 report for the International Fiscal Association, divides the costs of operating a tax system into administrative and collection costs, borne by the tax authorities, and compliance costs, borne by the taxpayer or his associates. The operation of income tax is at present being altered in this sense to self-assessment for the self-employed; death taxes have been essentially self-assessed for many years, now through the 30 IHT4XX forms. These forms total 118 pages, and strenuous knowledge of the taxpayer's holdings, up-to-date valuations, and other areas – this is a very heavy burden, which can be made especially difficult if the taxpayer is in a disabled, as often happens later in life.

This may require additional expenditure on behalf of the taxpayer, such as purchasing legal and probate services, which cannot be deducted from the later tax.

Thus, the operation of a very complicated system of taxation has been substantially devolved, or foisted, onto the taxpayer. It is indeed a much more complicated system than income tax.

In accordance with usual practice, the taxpayer is threatened with penalties if they makes any

12 David Burgherr, 'The Costs of Administering a Wealth Tax', Wealth Tax Commission, n.d.

mistakes in the course of completing this paperchase. Many of the executors required to fill in these forms are people who have no regular dealings with the tax authorities because they have income from employment, taxed under Pay As You Earn, or from investments taxed at source.

But the compliance cost of inheritance tax is particularly high, partly because it is so near the logical extreme of self-assessment.

Costs of direct tax allowances and reliefs

The tax-free band below the threshold (£325,000 in 2023) cost the Exchequer a total of £26.3bn in exemptions and reliefs from the tax in 2021-22, resulting in a negative output in so-called subsidy (as defined as an exemption from a tax despite being otherwise liable) of well over the revenue from the tax.[13] Partially, this exemption is allowed for by administrative cost, thus, HMRC is using up resources to gain no tax. Thus, this is a tax like the pre-war income tax, paid only by a small minority and levied on a fraction of its potential base. Since 1938-39, death duties have fallen from 15 per cent to 0.766% of National Account Taxes, while income tax has become payable by almost everyone in a full-time job. [14]

The present reliefs have been conceded in response to persistent pressure and are unlikely to be restricted; indeed, business and agricultural reliefs have been steadily enlarged. So, given the national and international tendency to broaden the bases of existing taxes, is there a place in the system for a tax whose yield has shrunk under political and economic pressure to less than a fifth of its potential?

SECOND-ROUND AND SUPPLY-SIDE ARGUMENTS

Multiple taxes on saving

Since saving has a time dimension, which spending has not, it is more vulnerable to attack by the tax authorities. Saving may be taxed when it is invested (stamp duty), while it is held (income tax), when it is given away or bequeathed (inheritance tax) and when it is reinvested or realised (capital gains tax).

A wealth tax has never been levied in the United Kingdom, although it was at one time considered a serious possibility, before being rejected due to the costs of compliance against the revenue raised.

Stamp duties are levied on the acquisition of certain assets; although they yielded some £20.5bn in 2023, they are ignored here because (1) they are not an annual tax, and (2) the rates of duty are relatively low.[15] In what follows, we are therefore concerned with the interplay of inheritance tax with income tax and capital gains tax.

Capital gains tax is not charged on death, unless the asset is disposed on by the estate on the

13 "Inheritance Tax Statistics: Commentary," GOV.UK, accessed February 8, 2024, https://www.gov.uk/government/statistics/inheritance-tax-statistics-commentary/inheritance-tax-statistics-commentary.

14 PSF_aggregates_databank_Nov_EFO_edition

15 "Public Finances Databank 2022-23," Office for Budget Responsibility, accessed February 8, 2024, https://obr.uk/public-finances-databank-2022-23/.

taxpayer's death, and to this extent capital gains tax and inheritance tax are alternatives. Lifetime gifts attract a charge to capital gains tax as well as a potential charge to inheritance tax: if a taxpayer makes a gift and then dies the next day, the estate is allowed a deduction but not a relief for the charge to capital gains tax in the computation of the inheritance tax liability. Since gifts made more than seven years before death are not liable to inheritance tax, the effective rate of inheritance tax on the transfer of assets varies between zero and 40 per cent (gross) of the value of the estate.

Total burden on taxpayers

The combined weight of income tax, capital gains tax and inheritance tax can be many times the yield of a taxed asset.

However, each of the three taxes on saving reduces the scope for the other two and the maximum rates at which they can be imposed. Income tax, capital gains tax and inheritance tax are all taxes on the original act of saving and their effect is cumulative: each increases the burden imposed by the others, measured in terms of the yield. Moreover, many assets that escape capital gains tax on death attract a charge to inheritance tax and many assets that escape inheritance tax attract a charge to capital gains tax, so that the two taxes complement each other in increasing the burden of tax on the original act of saving.

Laffer Curve

The idea that taxation can be too heavy, not only for the taxpayers but also for the tax collectors, was known even to the ancients The concept was given mathematical form by the French engineer A.J.E.J. Dupuit in the mid-nineteenth century; and the curve of tax revenue, rising from zero to a maximum and falling to zero again as the tax rate increases, has been popularised in recent years by the American economist Arthur Laffer.

The empirical evidence supports the theoretical argument that the combined taxes on saving reach a revenue maximum at or below about 50 per cent gross. As long as income tax is charged at up to 40 per cent, there is little room, if any, for taxes on inheritance and capital gains.

The UK figures confirm the Dupuit/Laffer principle. For income tax, including income tax on earnings, the Inland Revenue publishes figures breaking down the shares of total tax liability by percentile. The share of the top 10 per cent rose from 35 per cent in 1978-79 (when the top rate of tax was 83 per cent on earned income and 98 per cent on investment income) to 39 per cent in 1986-87 (when the top rate was 60 per cent) and to 43 per cent in 1993-94 (when the top rate was 40 per cent).

For death duties, we know of no extensive studies of the rate and return relationship. But it is suggestive that the share of HMRC taxes was so much higher when in the early days of estate duty the top rate of tax was 8 per cent gross than it is now that the top rate is five times as high at 40 per cent.

Second-round effects of a tax reduction

The apparent cost of a reduction or abolition in inheritance tax would be offset by increases in the yields of income tax, capital gains tax, value added tax and other taxes. When aggregate tax revenue is appropriating over 40 per cent of national income, as it is at present, over 40 per cent of the apparent or first-round cost of a tax reduction returns to the Exchequer in the second and subsequent rounds as it is spent or invested by the taxpayers concerned. The true cost of a tax reduction, including a reduction in inheritance tax, is thus much less than the apparent cost.

Inheritance tax is levied disproportionately on the most entrepreneurial elements of the economy. Inheritance tax is thus exceptionally damaging per pound of revenue yield by reason of the activity (and associated tax revenue) that it frustrates; and reductions in inheritance tax are correspondingly cheap (or self-financing).

Similarly, new investment can be attracted from abroad by a relatively favourable inheritance tax regime; an unfavourable regime is an incentive to emigrate or keep funds abroad. This has been outlined by the lessons of Norway, which saw many of its most wealthy leave for Switzerland after the wealth tax was increased to 1.1%.[16] For bequests in the direct line to children and grandchildren (the most important single category of bequests) the United Kingdom tax regime is one of the harshest when compared to the EU.

Government costings

The government's method of costing tax changes does not include any effect the tax changes themselves may have on levels of income and spending. Even on this basis, inheritance tax would be exceptionally cheap to cut. The full effect is not felt for several years, and only two-fifths of the full effect would be felt in the first year.

But the Treasury ignores both the behavioural effects and the second round effects of tax changes, since both affect "levels of income and spending". The advantage of this method for the Treasury is that the first round figures can be computed more accurately than the second-round and behavioural effects. The disadvantage is that the figures address the wrong question. They do not say how much the Exchequer will gain or lose in revenue from a tax change but merely how much it will gain or lose in the first round on the restrictive and unrealistic assumptions employed. The Treasury would rather be precisely wrong than approximately right.

The assumption that income is unchanged also leads to a serious policy error. Experience over the last fifteen years has shown that mobile international capital is substantially beyond the reach of taxation at least in the host country or country of source. Much of the inheritance tax base is likewise internationally mobile and its owners likewise wish if possible to preserve its net-of-tax value or at least to escape the tax. The low yield of inheritance tax at the high rate of 40 per cent suggests that they are largely successful, whether through emigration, tax planning, concealment, spending or otherwise.

Exchequer risk and reward

Inheritance tax at present yields some £7bn a year, and this is the first-round cost of its abolition. Much of this cost would be offset in the second and subsequent rounds by additional tax on the additional spending and investment funded by the abolition of inheritance tax. With tax in total taking some 36% per cent of GDP in 2022-23, these second-round offsets amount to some £520 million, so that the net cost is some £780 million a year in 1994 values, say £800 million. This is the maximum cost to the Exchequer if there are no further offsets.

However, the assumption of no further offsets is a logical extreme. In practice, it is to be expected that personally owned capital will increase by more than the additional saving funded by the abolition of inheritance tax: the inward movement of capital will rise and its outward movement will fall;

16 023, sec. World news, https://www.theguardian.com/world/2023/apr/10/super-rich-abandoning-norway-at-record-rate-as-wealth-tax-rises-slightly.

saving and investment will rise at the expense of spending, which is taxed less heavily; efficiency will improve with the reduction of tax distortion; and there will be less concealment and evasion.

The Exchequer may gain instead of losing from the abolition of a tax; and on less conservative assumptions the gain could be more, perhaps much more, than the £7bn first-round cost of abolition. In Australia and Canada, the forces of tax competition left the states and provincial governments, respectively, with little choice but to abolish death duties; and there is no reason to believe that tax competition is less powerful in Europe.

CASH FLOW AND ACCRUAL

Another reason why the real cost of abolition could prove negative is the difference between cash flow and accrual.

The accounts of commercial firms that are subject to professional audit are drawn up on the accrual's basis, that is, after inclusion of increases and decreases in creditors and debtors. But it is a requirement of business survival that a firm's cash flow should be satisfactory as well as its accrual based accounts. Both are necessary. If its profit projections are healthy but not its cash flow, it may fail because it cannot pay its day-to-day bills. If its cash flow is adequate but not its profit projections, it is living on borrowed time and storing up trouble for the future.

Central government accounts in the United Kingdom are still prepared and published based on cash flow. This procedure has numerous inconveniences. On the expenditure side, there is no effective distinction between current and capital spending nor between cost-reducing capital expenditure (such as some forms of office equipment) and cost-increasing capital expenditure (such as on schools or hospitals). On the revenue side, it precludes the policy option of investment in a tax reduction.

As has been recognised from the beginning of estate duty, death duties take productive capital from individual owners and transfer it to the government to spend as income. The uneconomic and destructive character of a tax on death takes four separate and cumulative forms.

- First, it is a tax on capital the proceeds of which are available to be spent as income.
- Second, it removes capital from the hands of those who know best how to use it productively.
- Third, once the holdings of personal capital have been destroyed, they no longer exist to be taxed a second time (as is confirmed by the disappearance of many landed estates and family firms).
- Fourth, it discourages or prevents the accumulation of new holdings of capital to take the place of those that have been taxed away.

Death duties are like a firm's reduction of advertising, research and development to improve its short-term cash flow and bottom line. In the first year or two the firm's policy is almost certain to succeed, although the more far-sighted commentators and analysts may have misgivings. Sooner or later, however, the firm will go under unless the policy is revised. The government, of course, does not go under: it simply makes up the shortfall with yet more taxes, whether in the short-run, or long-run by borrowing.

The present cash-flow method computes each year based on receipts during that year without taking account of future offsets (lower future receipts offsetting higher current receipts), whereas the accruals method takes immediate account of future offsets at the appropriate rate of discount. There is reason to believe that the accrued damage inflicted by death duties not only on the economy but even on the Exchequer has outweighed the first-year or cash-flow benefits to the revenue for many years.

After the centenary of estate duty in 1994, it is none too early to suggest that, if the government had imposed on itself the discipline of accruals accounting, which is a necessary condition of survival for commercial firms, the yield of estate duty would have been negative in each of the hundred years since 1894. Death duties are a tax on seed corn, and it is to be expected that they will damage not only the economy but even the Exchequer.

In many parts of the country, such as the West Midlands or Yorkshire, many or most of the long-term family companies that used to be the typical form of business organisation have been driven out by death duties and acquired or replaced, if at all, by quoted companies or their subsidiaries. Quoted companies have been shedding labour in recent years and the unquoted sector is the principal source of new jobs in the market economy. Inheritance tax has thus served to increase unemployment, and the present economic recession would have been less severe if death duties had been abolished a generation ago. [17]

Similarly, there is usually no one who will look after heritage property so cheaply or efficiently as the historic owner other than the National Trust or English Heritage; but only a small proportion of heritage property is covered by reliefs from death duties, and the already difficult task of keeping up large properties has often been made impossible by taxation. Important properties have decayed or been abandoned or have required subsidy from the public purse. Here again, the losses to the economy and the Exchequer have been substantial, to say nothing of the reduction in the quality of life.

SHORT TERM AND LONG TERM

It is sometimes said that the purpose of saving is to increase future consumption; but I have argued that ownership has an economic life and value of its own. Ownership is a use of funds alternative to consumption, now or in the future. Capital is indeed a source of potential funds for spending; but the capital may never be drawn down, and there may be no intention ever to draw it down. The accumulation of capital to generate additional income is saving in perpetuity, a concept quite different from that of saving for future consumption.

Temporary saving and ownership are producer activities. Saving and ownership in perpetuity are a mixture of producer and consumer activities. They are producer activities in so far as they require effort (the forgoing of present or future consumption). They are consumer activities in so far as they yield economic satisfaction.

But the quality of production predominates, as it does when people enjoy their work: work sold on a free market is still production even if it is enjoyed. The enjoyment reduces the economic cost, effort or disutility of the work and may turn it negative; but the value of the output is still positive.

17 'The State of the Nation: the UK Family Business Sector 2021/2022', accessed 24 December 2023, https://www.familybusinessuk.org/wp-content/uploads/2023/06/the-state-of-the-nation-the-uk-family-business-sector-20212022.pdf. p24.

So, it is with saving and ownership in perpetuity. Ownership in perpetuity creates wealth because the money works twice, once for the saver and once for the owner, even though they are the same person, the more the enjoyment, the more the owner gains.

In practice, the United Kingdom government conspires against this process of wealth creation, making saving expensive through the taxes it imposes. Despite the political rhetoric, governments of both Parties have been and remain in practice, with limited exceptions, hostile to the principle of personal ownership. With personally held wealth of some £15.2 trillion, the potential losses from present policies towards personal ownership are very substantial.[18]

Tax distortion

The bias of policy against personal ownership is found in several tax distortions, each of which has caused a significant loss of economic wellbeing. Inheritance tax does not destroy wealth in the material sense of iconoclasts desecrating churches; but it distorts choices and annihilates immaterial wealth in the mind of the taxpayer, and the effect on economic wellbeing is no less damaging.

The simplest example of a tax distortion is the effect of inheritance tax on the choice between spending and saving. “That men labour and save chiefly for the sake of their families and not for themselves,” says Alfred Marshall in his *Principles of Economics*, “is shown by the fact that they seldom spend, after they have retired from work, more than the income that comes in from their savings, preferring to leave their stored-up wealth intact for their families... The chief motive of saving is family affection.” [19]

Thus, saving in perpetuity is the preferred use of funds for most families. This preference is distorted and frustrated by inheritance tax, since the taxpayer expecting to pay the tax can have £100 of spending for each £60 of net-of-tax bequests.

It is also paradoxical that under a regime of inheritance tax at 40 per cent, the poor man’s spending costs him £100 whereas the rich man’s spending costs him only £60.

Unquoted companies

Another distortion inflicted on the economy by inheritance tax is the burden it imposes on unquoted companies and other owner-managed family firms from which quoted companies are effectively exempt. In quoted companies’ death duties fall nominally and effectively on the shareholder; the shareholder can sell shares to defray the tax charge, and the company may be little affected, if at all. In unquoted companies’ death duties fall nominally on the shareholder but effectively on the company itself: the shareholder seldom has cash resources to meet a significant liability, and the liability must be discharged either indirectly and expensively through the company (which weakens the company financially) or through sale to outsiders (which alters the company’s character).

The quality of owner-management, which gives unquoted companies and other unquoted businesses their long time-horizons, thus attracts a discriminatory tax charge to which quoted companies are effectively immune. Once again, inheritance tax makes the economy more “short-termist”.

The liability of unquoted companies to inheritance tax in the absence of entitlement to 100 per

18 Total Wealth: Wealth in Great Britain - Office for National Statistics, January 7, 2022, https://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/incomeandwealth/datasets/totalwealthwealthingreatbritain.

19 Alfred Marshall, ‘The Online Library of Liberty’, Principles of Economics, 2011. p130.

cent business relief is particularly damaging given the dominant motivation of long-term family companies. The families who own unquoted companies desire to maintain control, and to pass on a secure and sound business to the next generation. In these circumstances, inheritance tax casts its shadow and distorts behaviour many years in advance of a taxable transfer and does damage out of proportion to its modest yield. The perception of the tax as an ever present threat may be more important than the reality, especially as its real incidence depends on the lottery of death.

Damage to the capital market

There are wider effects. At least until recently, the personal ownership of shares has been in decline for many years: Schroder's research has shown a considerable decline in individual share ownership of companies in favour of institutional investors, insurance, and pension fund companies over the past 55 years. Individual ownership only makes up 10.8% of all UK stock as of 2022; in 1963 individuals made up over 50% of stock ownership.[20]

The reason for the decline in the personal ownership of shares has been above all the disadvantageous tax treatment of the personal owner by comparison with the institutional owner: in particular, the personal owner is liable to inheritance tax and is subject to capital gains tax on rearrangements of his portfolio.

The decline of the personal owner also has "short-termist" implications. On balance, personal share ownership has a longer time-horizon than institutional ownership. Loyalty to companies in the portfolio must inevitably rank low in the value scale of fund managers, whereas it may rank high in that of individuals. Cultural and legal biases in favour of institutional ownership relatively to individual ownership may increase the volatility of share prices and otherwise aggravate the problem of "short-termism" and hostile takeovers.

International Investment

Foreign investment does not often come into arguments about the role of IHT. International investment is, more commonly, seen as direct investments by third parties in capital and stock within nascent or blue-chip sectors, with £78.8bn in greenfield FDI in 2022 alone.[21] This is one side of the coin, however – individuals from high-net worth backgrounds may choose to relocate to the UK given its preferable standards of living and political liberties than other countries.

Inheritance tax proves a considerable obstacle to affluent immigration and capital injecting, with immigrants being forced to playoff easy relocation and heavy taxation on the second generation who stand to inherit a business. With 13% of the population being foreign-born in the East of England, and 10% of the North West, there are considerable opportunities for regional growth which are being avoided by the maintenance of IHT.[22]

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20 Duncan Lamont, 'Causes and Consequences of the Dramatic Changes in Ownership of the UK Stock Market in the Past 55 Years' (Schroders, November 2020), https://mybrand.schroders.com/m/4909773e93550aa9/original/2020-November-stock-market-ownership.pdf.; 1. Frank Donnarumma, "Ownership of UK Quoted Shares: 2022," Ownership of UK quoted shares - Office for National Statistics, December 4, 2023, https://www.ons.gov.uk/economy/investmentspensionsandtrusts/bulletins/ownershipofukquotedshares/2022.

21 'Harrington Review of Foreign Direct Investment', HM Treasury and Department for Business and Trade, accessed 27 December 2023, https://assets.publishing.service.gov.uk/media/655f62310c7ec8001195bd5f/231123_Harrington-Review-Report-FINAL-2__HH_Global_.pdf.

22 'Migrants in the UK: An Overview', Migration Observatory, accessed 27 December 2023, https://migrationobservatory.ox.ac.uk/resources/briefings/migrants-in-the-uk-an-overview/.

Conclusion

The policy implication of the argument is therefore that the damaging distortions caused by inheritance tax (and other taxes on saving) should be removed by the abolition of the offending taxes.

The advantageous treatment of financial institutions relatively to personal owners may be corrected by curtailing the tax privileges of the institutions or by extending them to natural persons. But saving is taxed too heavily, not too lightly, and indeed that there is no satisfactory way of taxing savings: aligning the tax treatment of institutions and natural persons should therefore be achieved by extending to natural persons the favourable treatment at present enjoyed by the institutions. This argument has been discussed at length elsewhere.